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SUBJECT: NEPAL'S ECONOMY FACES MAJOR CHALLENGES

¶1. (SBU) Summary: Nepal's economy, already damaged by a decade of civil conflict, faces balance of payments and liquidity problems, a real estate price bubble, slowing remittance growth, and a shaky (and partially unregulated) banking sector. The IMF, central bank and leading bankers do not warn of an imminent economic or banking crisis, but they acknowledge there are danger signs. End Summary.

#### Balance of Payments and Liquidity Challenges

¶2. (SBU) Nepal is facing its first balance of payments deficit in many years. In the first quarter of the current fiscal year, which began in mid-July, the deficit totaled Rs. 20.5 billion (about USD 280 million), compared to a Rs. 11.8 billion surplus in the same period last year. During a January 26 meeting with the Charge, Krishna Bahadur Manandhar, Acting Governor of the Nepal Rastra Bank (NRB), the country's central bank, blamed the deficit largely on a Government of India's decision to increase tariffs on gold imports, while Nepal kept it tariff rate the same. Illegal traders took advantage of this gap to import gold into Nepal, then smuggle it across the open Nepal-India border. The Government of Nepal (GON) has taken several steps, including slowing the customs clearance process, to rein in gold imports, which totaled 12.5 tons over the first six months of FY 2009/10, more than triple the amount imported during the same period last year.

¶3. (SBU) Nepal has also been experiencing a liquidity crunch, which pushed interest rates to 11-13 percent, up from 5-7 percent last year. Manandhar linked the ongoing liquidity crunch to the balance of payments deficit. The head of the Nepal Banker's Association, Sashin Joshi, told Charge that irresponsible bank lending also contributed to the liquidity crisis, as bank lending exceeded deposits. Other factors include the lack of government spending (the Maoist blockade of parliament delayed passage of the budget vote for four months) and last September's currency note shortage -- a result of poor planning by the NRB. The latter decreased confidence in the banking sector and led to more Nepalis holding currency. To combat the liquidity crunch, the NRB injected approximately Rs. 25 billion into the market, which

began to ease the credit crisis. IMF's representative in Nepal, Alexander Pitt, is "confident" the NRB's interventions will be effective. (Note: Pitt is the only expatriate IMF staff in Nepal, and his office is inside the Nepal Rastra Bank. End note.)

#### Remittances Still Increasing, but at Slower Rate

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¶4. (SBU) In recent years, banks have come to rely heavily on the flow of remittances from Nepalis working abroad, Joshi said. Last fiscal year, remittances, which amount to more than 20 percent of GDP, grew by 65 percent, while the growth rate so far this year has been just 6 percent. The dramatic growth in remittances in recent years, IMF's Pitt reported, has become "addictive" for banks, who rely on the flow of hard currency for their operations. Banks are having some difficulty adjust to the slower rate of remittance growth. Pitt said that the continued strength of the Asian economies, where many Nepalis work, has kept remittance flows from dropping.

#### Banking Sector Exposed, Partially Unregulated

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¶5. (SBU) The dramatic rise in real estate prices -- some estimates suggest they have tripled in the past year -- creates risks for Nepal's banks. While the majority of lending is for trade and manufacturing, some banks are significantly exposed in the real estate market. Additionally, as one prominent banker told the Charge, regardless of their purpose, "all the loans are

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collateralized by real estate." It is unclear how many of the real estate loans are purely speculative versus real, according to IMF representative Pitt. NRB chief Manandhar said his concern is not that real estate prices will begin to fall, but rather the rate of increase will slow, which would spell trouble for banks. Pitt agreed "danger signs are there," but added a "mass banking collapse" is unlikely. There is no deposit insurance in Nepal, increasing bank instability, although the NRB has recommended to the GON that they consider developing an insurance scheme.

¶6. (SBU) NRB's Manandhar is "seriously concerned" about the growth of cooperatives, a Nepali financial institution similar to credit unions. Cooperatives are beyond the jurisdiction of the NRB, and while the Ministry of Finance technically oversees the more than 15,000 cooperatives, it lacks resources and capacity needed for effective regulations. Banker's Association President Joshi, who estimates cooperatives' assets total Rs. 60 to 65 billion, said managers of some of the large cooperatives invest deposits largely in high-risk real estate deals, while maintaining reserves as little as one percent. He cautioned that, once the real estate market slows, cooperatives could begin to fail, and, if one fails, it could create a panic.

#### Keep the Indian Currency Peg

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¶7. (SBU) The IMF and NRB both strongly support the current policy of pegging Nepal's currency to the Indian rupee. NRB's Manandhar said allowing the Nepali rupee to float would be a "lose-lose proposition." IMF's Pitt said the peg was a "pillar of stability," adding the NRB does not have the capacity to manage a floating exchange rate. Given the thin market for Nepali rupees, the both argued, a floating exchange rate would also invite speculation.

#### Macroeconomic Picture Generally Stable

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¶8. (SBU) Despite the many economic challenges, Pitt reported that Nepal's overall macroeconomic picture is generally sound. This year's budget deficit may slightly exceed the IMF recommended target of 2 percent, due to unbudgeted demands such as increases in civil service salaries and payments to former Maoist combatants, but revenues are doing

well. The IMF does not have a program in Nepal, but plans to start discussions with Nepal on a precautionary program, likely focused on financial sector reform. The next IMF Article IV visit is scheduled for February 24.

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